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TAGS: ECON EIND ETRD IN
SUBJECT: INDIAN IT AND TEXTILE INDUSTRIES STRUGGLE TO COPE WITH MATURING BUSINESS MODELS AND A RISING RUPEE

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¶1. (U) This cable is classified as sensitive but unclassified. Please treat accordingly.

¶2. (U) Summary: India's two largest foreign exchange earners - the textile and IT industries -- are struggling to adjust to the appreciation of the Indian rupee against the dollar. However, in a series of discussions with interlocutors from the IT and textile industries, Congenoffs learned that the rising rupee is just one of many problems faced by the two industries. The software industry's trade association, NASSCOM, said expectations of a slowing U. S. economy and a human resource crunch resulting from the booming domestic economy are equally responsible for the industry's current challenges. A representative from the textile industry also noted that the expectation of a slowdown in the U. S., coupled with the expiration of the multi-fiber agreement, have also hit the industry. Both industries are trying to cut costs and are looking to new export markets for revenue. While the IT industry has been trying to lobby the Government of India to preserve tax breaks on exports, the textile industry has been trying to obtain similar tax breaks. Irrespective of whether they are successful, both industries feel the imperative to develop innovative strategies and re-tool business models to stay afloat and weather the current crisis. End Summary.

IT and Textile Industries Among Biggest Export Earners

¶3. (U) The information technology (IT) and textile industries are important export industries and foreign exchange earners for the Indian economy. In 2007, the IT industry's revenues touched USD 39.6 billion of which USD 31.4 billion were exports. At the end of 2007, the industry directly employed 1.6 million people and accounted for 5.4 percent of India's GDP. After years of fast growth, the IT industry is well-represented with the top 20 IT companies, who generate 80 percent of export revenues of the industry. The industry is projected to grow 12-15 percent in 2008 after years of 30 percent plus annual growth. Estimated to employ 2.5 million people, the textile industry is one of India's oldest industries. The textile industry's export revenue stood at USD 20 billion and accounted for one-sixth of

India's total export revenue in 2006 according to DGCIS (Directorate General of Commercial Intelligence & Services) data. The textile industry is very fragmented, with almost 300 exporters earning revenues over USD 25 million.

Twin Impact of Rising Rupee and Slowing U.S. Economy Too Much Too Fast
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¶4. (U) Rajiv Vaishnav, Regional Director of the National Association of Software & Service Companies (NASSCOM), told Congenoffs that the profitability of the Indian IT industry has recently taken a double hit: first, by the speed of the rupee appreciation via-a-vis the dollar, and second, by the slowdown in the U.S. economy. The Indian IT industry has primarily been export driven with the domestic IT industry accounting for only around 20 percent of the total industry revenues, Vaishnav explained; of these exports, the U.S. market accounts for over 50 percent. The slowdown of the U. S. economy has therefore dampened future growth prospects for the industry, although he admitted that the immediate fallout is lower profit margins, rather than decreased growth. In a separate discussion, Atul Nishar, the chairman of Hexaware Technologies, confirmed this trend. He reported that while his company's profit margins had been impacted, sales growth largely remained intact despite the company's dependence (more than 50 percent of sales) on the U.S. market.

¶5. (U) In a separate discussion, Rahul Mehta, the President of the Clothing Manufacturers Association of India (CMAI), pointed out that the speed at which the rupee appreciated (12 percent since January 2007, with a rise of almost 10 percent since April 2007) caught textile exporters off-guard. If the rise had been spread over a longer period of time, he said, then exporters could have adjusted the pricing of contracts with their suppliers and customers. He stated that the impact of the stronger rupee via-a-vis the dollars was even more severe, as 70-80 percent of the textile industry's export revenues are dollar denominated. The U.S. accounts for 30-35 percent of the

industry's export market. All exports to Middle Eastern markets and 70 percent of European sales are also priced in dollars, he explained. Manojj Kumar Patodia of Prime Textiles, a major textiles manufacturing firm with mills in Tirupur in Tamil Nadu, confirmed that many of his company's European contracts were priced in U.S. dollars, and he was looking to switch to Euro pricing. Mehta also pointed out that the industry had an import content of just 3-5 percent, and therefore had little scope to offset the impact of the stronger rupee. He admitted that India's lowering of import tariffs for imported fabrics to meet its WTO commitments would increase the percentage of imported fabric content in textile exports.

¶6. (U) Moreover, Mehta continued, along with the weakening of the dollar, the slowdown in the U.S. economy has resulted in fewer orders and reduced margins. The industry had been able to handle this scenario in the past because the multi-fiber agreement had ensured that Indian suppliers had access to some portion of the U.S. textile market. But with its expiry, Indian manufacturers now have to compete with cheaper Chinese manufacturers and Southeast Asian manufacturers, he explained. Margins are therefore very slim for textile exports. He claimed that the average margin for a textile exporter is just 8-9 percent, so a 10-11 percent appreciation in the rupee has wiped out margins. As a result, several exporters are currently running their business at a loss and hope to ride out the crisis, he continued.

¶7. (U) In contrast to CMAI Mehta's claims, Patodia of Prime Textiles informed Econoff that, surprisingly, his business had started to turn around in the last month. Whereas he had partially retooled his business towards the domestic economy, he was also discovering that international buyers did not want to be solely reliant on China for their purchases and were willing to continue supplier relationships with Indian firms, despite their higher pricing, to diversify. Indian firms are reliable suppliers of high quality goods, which Patodia claimed many of his other South Asian competitors cannot promise. Tax sops or no tax sops, Patodia, for one, was optimistic about the business

outlook for the rest of the year.

IT & Textile Industry Both Lobby for Tax Breaks to Soften the Rupee Rise
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¶8. (U) Vaishnav informed Congenoffs that NASSCOM is lobbying the Indian government to preserve tax exemption on export earnings for IT industries under the Software Technology Parks of India (STPI) scheme. (Note: The government created the STPI scheme to encourage and enhance software exports from India by setting up dedicated software technology parks with good infrastructure, technology, and professional training services. The STPI is aimed at facilitating the software export industry and especially the SME (small and medium enterprise) segment to maintain a competitive edge in the global market. End Note.) Units in the STPI were given a 10-year tax holiday, which ends in March 2009. NASSCOM wants this extended for another 10 years. Congenoff pointed out that the Indian IT sector's pleas for continued tax breaks and other government sops to ensure its survival contrasted with the projection of its image internationally, in which industry representatives routinely boasts about its world class products and competitive pricing.
¶9. (U) Vaishnav maintained that these exemptions were critical for the SME segment of the Indian IT sector, which he claims is most severely affected by the rising rupee. While the larger IT companies have the financial resources and the knowledge to hedge against currency appreciation, small and medium IT companies do not, Vaishnav said. He claims that the withdrawal of tax sops under STPI will hit the SME segment disproportionately hard. Large IT companies can always move their operations to Special Economic Zones (SEZs) and thereby preserve these tax breaks. But smaller companies do not have this option because of the high rental cost at the SEZs, Vaishnav explained. NASSCOM has been lobbying the Indian central government to preserve these tax breaks for the last two years and Vaishnav believes that there is a 60 percent chance of success. Atul Nishar, the Chairman of Hexaware Technologies and the former Chairman of NASSCOM, was even more optimistic and expects tax relief in the coming budget. He pointed out that

the government will be seen as favoring large corporates and ignoring the SME sector if it removes tax benefits in STPIs but keeps these incentives in SEZs.
¶10. (U) CMAI's Mehta separately told us that like the IT industry, the SEZ model was not feasible for the textile industry which also primarily consists of small- and medium-sized players. The barriers between the domestic and export industry are breaking down in the textile sector, he noted. Textile exporters also sell their goods to the domestic market and while not prohibited, domestic sale from a company in an SEZ is an administrative inconvenience, he added.
¶11. (U) CMAI, like NASSCOM, is also lobbying the government for tax concessions. Mehta told us that the industry is demanding that textile exporters get refunds of state and local taxes paid in addition to the existing refund of federal tax. These account for 4-6 percent of the FOB (freight on board) price of the good, he added. Patodia of Prime Textiles called state and local taxes the number one impediment to his business. Mehta of CMAI also said that the industry is lobbying for a lowering of domestic interest rates of around 9 percent charged to exporters to the internationally prevailing 3-4 percent. The textile industry wants more flexible labor laws which permit temporary and contract employment in the textile industry, although he privately acknowledged that this is a tall order given the current political alignment in Delhi. Mehta added the industry was demanding cheaper and more reliable electricity supply.

Slowing U.S. Economy Forces Export Diversification
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¶12. (U) Vaishnav stated that the IT industry is now looking to diversify its export revenue base to Europe and Asia -- two relatively untapped markets -- to cope with the twin impact of a rising rupee and slowing U.S. economy. Vaishnav noted that the IT company Datamatics, for example, now obtains most its export

revenue from the U.K. Nishar of Hexaware added that his company is planning to reduce its exposure to the U.S. market from the current level of 68 percent to less than 60 percent. Nishar also believes that while the Indian IT industry will be badly hit in 2007-08, he expected that a revival of the U.S. economy in 2009 will lead more U.S. companies offshore to India as they become even more aware of cost efficiencies. The Indian IT industry will therefore see an uptrend in business in 2009-10, he opined. He sees the current business environment as similar to 2001-2002 when a slowdown in the U.S. initially hit the Indian IT industry hard but was followed by a sudden upswing in business as U.S. firms decided to increase off-shoring to contain costs and build shareholder value.
¶13. (U) Meanwhile, CMAI's Mehta stated that Indian textile manufacturers were also looking to diversify into new markets. He himself led a trade delegation under CMAI to Chile and will soon take a delegation to China, which Mehta claimed was open to receiving exports from India because China's industry so dwarfed India's that it did not feel threatened. Mehta admitted that the industry had been short-sighted, developing trade relations with the U.S., Europe and Middle Eastern countries at the expense of Latin American, Southeast Asian, Eastern European and East Asian nations. The industry is now looking at these markets as export destinations and not just as sources of supply.

Cost-cutting Measures to Stem the Impact

¶14. (U) NASSCOM's Vaishnav also told us that the IT industry is trimming costs to improve eroding bottomlines. The industry is trying to lower the salary expectations of its employees and is also cutting down on the "extra" benefits or frills given to employees. Analysts believe that the IT industry wage bill will appreciate by only 10-12 percent this year, as compared to an 18 percent rise in wages last year. Tata Consultancy Services, one of the largest Indian software exporters, shaved off around two percent of the variable pay linked to the company's performance from its employees' salary for the January-March quarter. Equity analysts believe this cut is designed to send a message to employees that all is not well with the IT sector, so as to lower their annual salary review expectations. Along with

managing wage costs, the industry is looking to expand to lower-cost Tier 2 and Tier 3 cities (smaller towns and cities); Vaishnav described this as the motivation behind the recent establishment of a new office of Datamatics Corporation in Nashik, Maharashtra, and the plans for Satyam to open an office in Nagpur. Hexware's Nishar confirmed these cost-cutting measures and said his company was not only lowering salary expectations but is also increasing the work day of its employees from 8 to approximately 9 hours a day. Nishar will also try to increase the percentage of employees being utilized at a given time, from the current 70-75 percent. Nishar added that his company, along with several other larger IT players, planned to increase billing rates both for renewals and new contracts to soften the impact of the strengthening rupee.
¶15. (U) CMAI's Mehta, told us that while large Indian textile exporters have cut staff to trim costs, some small manufacturers have simply been forced to shut down. He estimated that as of November 2007, the industry had lost 75,000 jobs, and he expects 150,000 job losses by March 2008. (Note: Mehta confidentially admitted that many of these "laid-off" workers were absorbed into the booming domestic textile industry or went back to the villages to resume agriculture. End Note).

IT Human Resource Crunch Unlikely Fallout of the Booming Indian Economy
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¶16. (U) Vaishnav noted that the booming domestic economy has shrunk the large pool of professionals from other industries who wanted to move into the IT sector. For example, Vaishnav pointed out that whereas ten years ago, civil engineers were ready to enter the IT sector, few do so today because of the vast job prospects available in developing India's infrastructure. NASSCOM projects that India's emergence as a

preferred outsourcing destination has created the need for over 2 million professionals by 2010. It estimates a shortage of 500,000 skilled workers if remedial action is not taken.

¶17. (U) To address the potential human resource crunch, NASSCOM itself is establishing twenty new IIITs (Indian Institutes of Information Technology) to create highly specialized professionals with skill sets in emerging technologies that are not yet mainstream. The first five new IIITs, which will be established through public-private partnerships, are expected to be rolled out by 2008. NASSCOM has also partnered with the Ministry for Human Resource Development to create the "finishing schools for engineering students" program to equip young professionals with the necessary skill sets to be directly employable in the IT industry. This program will help reduce training costs for new entrants to the industry. NASSCOM has also launched an industry standard assessment and certification program - the NASSCOM Assessment of Competence (NAC) - to ensure a steady stream of employable talent especially for the outsourcing sector.

¶18. (U) In contrast, Mehta warned that a downturn in textile industry employment hurts a particularly vulnerable segment in Indian society. The textile industry offers job opportunities for illiterate or semi-literate workers. Moreover, the industry utilizes unskilled and semi-skilled workers and offers safe employment to women, he noted. The industry is not location specific and can be set up even in economically backward areas of India, Mehta claimed. It costs around USD 250 to create 4-5 jobs in this industry as compared to an expenditure of USD 12,000-15,000 for 4-5 jobs in the IT sector, he added. For these reasons, Mehta argued, the textile industry, which is one of the highest net foreign exchange earners for India, should receive the same favored treatment that the IT industry receives from the Indian government.

But Booming Domestic Economy Also Creates New Options
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¶19. (U) An upside to the booming Indian economy for the IT industry is that it has also enabled the industry to obtain more of its revenue domestically and thus hedge against foreign exchange fluctuation, Vaishnav noted. He pointed out that the industry currently obtains over 20 percent of its revenues domestically versus under 14 percent five years ago. He noted that this trend will continue as the Indian economy continues to

grow in productivity. Vaishnav singled out the domestic banking industry and telecommunications industries for contributing to this trend. He also believes that the organized retail sector has the potential to be a future driver. In tandem with this revenue diversification, the industry has also started offshoring jobs itself in order to better service clients. Vaishnav pointed out that the industry has been hiring in China and in the European Union and is now looking to hire in Vietnam, Israel and the Philippines. Atul Nishar of Hexware confirmed this phenomenon, called "near-shoring," and stated that his company had opened up a software testing facility in Mexico even though employees receive salaries twice as high as those in India, to be in the same time-zone as American customers. Nevertheless, he emphasized that hiring in India is still a smarter option because of relatively cheap labor costs given the skill of the employees.

¶20. (U) Similarly, Mehta admitted that formerly export-oriented textile companies are quickly tuning their business models towards India's domestic economy. He informed Econoff that the booming domestic garment industry has caused nearly all exporters, including himself, to switch to domestic-oriented operations. Textile and clothing manufacturers are also investing in improving the technology used in their factories. CMAI stated that the industry is also looking to move up the value-chain into higher quality products which were fashion-related or technology-related like the bullet-proof vests and parachute parts that Econoff saw being manufactured during the recent tour of a textile factory in Surat, Gujarat. In a separate conversation, Sanjay Lalbhai, Managing Director of Arvind Mills in Ahmedabad Gujarat, one of India's largest textile companies, told Congenoff that the rupee's rise has

forced his company to look hard at the domestic market, which is growing fast. Arvind Mills has exclusive sales and manufacturing contracts with major foreign clothing companies, such as Benetton and Tommy Hilfiger, for which there is an emerging Indian market for higher end clothing.

Comment:

¶21. (SBU) Once the main export revenue generator of the Indian economy, the textile industry now struggles in the shadows of "new economy" exports, such as engineering goods, petroleum products, and the IT sector. The textile industry traditionally was a huge income source for politicians and officials, who traded much-needed license and manufacturing permits under the "License Raj" for campaign funds and pocket money. The IT industry, in contrast, evolved largely outside of government regulation and political interference, a respite for which its boosters are grateful. Now, both industries find themselves in the same boat, facing a rising rupee that erodes profits in an environment of increasingly global competition. For this, not surprisingly, representatives of both are turning to the government for help in advance of the upcoming budget session of Parliament. Whether the Indian government will provide tax breaks or other kinds of help is uncertain; what is certain that once given, tax breaks and other sops are hard to take away, even when an industry returns to health. In addition, though, both industries are also trying to diversify and restructure away from dependence on the U.S. market and the dollar. Not every firm will succeed, especially the smaller ones, but it is external pressures such as these that often leave industries leaner and meaner. Although fraught with political difficulties, the threat of huge job losses in the labor-intensive textile industries might be one of the best opportunities to push the government for more labor flexibility that allows re-absorption of low-skilled workers. End Comment.
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